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BEFORE THE
POSTAL REGULATORY COMMISSION

Periodic Reporting (UPS Proposals One, Two, and Three)	: : :	**Docket No. RM2016-2**

REPLY COMMENTS OF UNITED PARCEL SERVICE, INC. REGARDING UPS PROPOSALS ONE AND TWO (March 25, 2016)

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INTRODUCTION

The exchanges in this docket have shown how the Postal Service's cost attribution practices, as they exist today, must be changed to comply with Congress' mandates in the Postal Accountability and Enhancement Act of 2006 ("PAEA"), and specifically in 39 U.S.C. § 3633, which governs the rates of competitive products.

In 39 U.S.C. § 3633(a)(2), Congress directed the Commission to "ensure that each competitive product" sold by the Postal Service "covers its costs attributable," including all "direct and indirect postal costs attributable . . . through reliably identified causal relationships," 39 U.S.C. § 3631(b). The Postal Service has now acknowledged, however, that it is taking an extraordinarily narrow approach to its cost attribution responsibilities.

Despite Congress' command that each competitive product must recover all *direct and indirect postal costs* attributable to that product, the Postal Service attributes only the smallest possible variable cost — its *marginal* costs — to competitive products, along with a trivial amount of product-specific fixed costs. By failing to attribute (and instead treating as "institutional") all of the other variable costs incurred before the hypothetical last unit of delivery, the Postal Service is minimizing the costs attributed to competitive products to a degree that is flatly incompatible with the statutory mandate.

These other variable costs are called "inframarginal" costs, and the Postal Service has now conceded that, since PAEA was passed, the Postal Service has not attributed *a single dollar* of these other variable costs to a *single one* of its competitive products. The Postal Service has refused to do so even as its own economist acknowledges that inframarginal costs must be recovered by revenues in order to break even.[1]

The Postal Service is engaging in this costing approach even as it is increasingly staking its future on parcel delivery and prioritizing competitive products in its investment decisions. The Postal Service has made clear it plans to use cost savings from its network rationalization — which increased delivery times for market-dominant products — to invest in package processing and automation.[2] The Postal Service's extremely narrow cost attribution approach, however, means that all variable costs other than marginal costs fall into the "institutional" cost pool — which costs are largely borne by market-dominant customers.

As parcel volume increases and market-dominant volume declines, this result becomes increasingly untenable. For example, the Postal Service plans to purchase a new fleet of 180,000 delivery vehicles with over three times the cargo space of its current delivery vehicles.[3] The cost of those vehicles will mostly be treated as

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[1] *See* Michael D. Bradley, Analysis of UPS Proposals One and Two, and the Supporting Report of Dr. Kevin Neels at 30, Dkt. No. RM2016-2 (Jan. 27, 2016) ("Bradley") ("To break even, the Postal Service must recover . . . its inframarginal costs. . . .").

[2] *See* U.S. Postal Service, Phase 2 Network Rationalization at 2 (2014), https://about.usps.com/news/electronic-press-kits/our-future-network/assets/pdf/ofn-phase-2-faqs.pdf ("[C]ost savings realized through [network rationalization] and other initiatives should better position the Postal Service to make needed investment in package processing and other automation equipment, and in [its] delivery fleet.").

[3] The Postal Service recommends that the new delivery vehicles have 330 to 400 cubic feet of cargo space. *See* U.S. Postal Service, U.S. Postal Service Next Generation Delivery Vehicle Supplier Conference at 4 (2015). The Postal Service's current standard delivery vehicles have only 108 cubic feet of cargo space, or less than a third of the Postal Service's recommended cargo capacity for its new delivery vehicles. *See* Government Accountability Office, GAO 11-386, Strategy Needed to Address Aging Fleet at 9 (2011), http://www.gao.gov/assets/320/318032.pdf.

institutional,[4] and the Postal Service will be free to cover up to 94.5% (in light of the current "appropriate share" requirement) of the cost of these parcel-delivery vehicles using revenues from market-dominant mail, at the expense of market-dominant customers. Yet, the larger vehicles are clearly intended to accommodate large volumes of *parcels*,[5] and will cost more to purchase and maintain than would a smaller fleet intended to support falling market-dominant mail volumes.

This result is not just bad policy. By refusing to attribute more than marginal costs to competitive products, the Postal Service is failing to abide by PAEA. As UPS explained in its opening petition, PAEA addressed the Postal Service's request for greater flexibility to price parcels so the Postal Service could compete more aggressively against private sector companies by acting more like a private sector company itself. This initiative posed a new challenge for postal regulation. The Postal Service is a state-owned enterprise that has built over 200 years a massive network to deliver the nation's letter mail, a service over which the Postal Service has a monopoly protected by federal law. Now the Postal Service was asking to use that same network to compete against private sector companies. Congress recognized that, if the Postal Service is allowed to treat competitive products as riding on the backs of its monopoly-

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[4] *See* United Parcel Service, Comments of United Parcel Service on Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Twelve) at 3-4, Dkt. No. RM2016-3 (Dec. 4, 2015).

[5] *See* Postal Service Office of Inspector General, Rep. No. DR-MA-14-005, Delivery Vehicle Fleet Replacement at 3 (June 10, 2014), https://www.uspsoig.gov/sites/default/files/document-library-files/2015/dr-ma-14-005.pdf ("[G]rowth in the package market could help dictate the design and technologies selected for a new vehicle."); U.S. Postal Service, Request for Information and Prequalification/Sources Sought for Next Generation Delivery Vehicle (NGDV) Acquisition Program at 1 (2015) ("The NGDVs are expected to share some design similarities with current [delivery vehicles], but will also need to incorporate changes to accommodate new market projections for mail and package delivery volumes.").

protected network, and if competitive products are not required to pay the *full* share of their costs, then competition in parcel markets would be heavily tilted in the Postal Service's advantage.

Congress enacted 39 U.S.C. § 3633(a)(2) to address this concern. The *principal goal* of this and other provisions of § 3633, as established by a wealth of legislative history, is to ensure that "the Postal Service *will compete on a level playing field*, under many of the same terms and conditions as faced by its private sector competitors, albeit *with stronger controls, oversight, and limitations* in recognition of its governmental status." H.R. Rep. No. 109-66 at 44 (2005) (emphasis added). As part of that oversight and those limitations, Congress made clear that the Postal Service is *not* allowed to ignore the costs of its competitive products or to bury those costs in accounting entries elsewhere in the enterprise. As UPS has shown, however, that is precisely what the Postal Service is doing today.

In opposing Proposal One, the Postal Service and Amazon economists, Drs. Bradley and Panzar, offer the same narrow positions on cost attribution that these long-time postal economists first offered decades *before* PAEA was passed (and thus before the category of "competitive products" was created). While there is some difference between the positions of these two economists, with Dr. Bradley arguing for attribution of "marginal" costs and Dr. Panzar arguing for attribution of "incremental" costs, this difference is not significant in practice, given the similarity of marginal and incremental cost calculations at the individual product level.[6] More striking is what is the same in

[6] As explained by Dr. Panzar, the mathematics of the constant elasticity model yield a very small difference between the calculation of "volume variable" (*i.e.*, marginal) cost and incremental cost at the individual product level, unless that product is

their positions: both rely on the premise that any cost that is not *directly and exclusively* caused by a single product cannot be attributed at all, and must instead be treated as an institutional cost (to be borne largely by market-dominant mailers).

This premise, however, is rejected by the plain language of PAEA, which provides for attribution of both direct postal costs *and indirect postal costs*. Indirect postal costs are precisely costs that may be attributed despite not being directly and exclusively caused by a single product. The Postal Service and Amazon are simply unable to reconcile their very narrow positions on cost attribution with this statutory command. *See* Section I.A *infra*.

Just as important, the decades-old positions of these economists entirely neglect the *purpose* of PAEA's requirement that each competitive product must recover its costs attributable: ensuring that the Postal Service's competitive products compete on a level playing field with private sector competitors. In fact, Dr. Panzar demonstrates that the theoretical outcome of his position (and the Postal Service's current practices) could be the *opposite* of what Congress prescribed. Specifically, he shows that, if the Postal Service's monopoly-driven network yields a lower *marginal* cost for Postal Service competitive products than for products sold by equally efficient private sector competitors, and the Postal Service's cost floor is set at marginal cost, competitive parcel markets will evolve to have a "*monopoly industry configuration*" dominated by the Postal Service. Declaration of John C. Panzar on Behalf of Amazon Fulfillment

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responsible for a very large proportion of the cost driver. *See* John Panzar, *The Role of Costs for Postal Regulation* at 23-25 (2014). For example, there is a less than one percent difference between "volume variable" and incremental costs even in the case of a single product making up 20% of the relevant cost driver, regardless of elasticity value. *Id*.

Services, Inc. at 27-28, Dkt. No. RM2016-2 (Jan. 27, 2016) ("Panzar") (emphasis added). Dr. Panzar calls this result "efficient." *Id.* at 27. But *Congress* certainly did not agree this result was efficient — or desirable in any way. *See* Section I.B *infra*.

Otherwise, the Postal Service and Amazon criticize how Proposal One works in practice. They misleadingly attack Proposal One as "arbitrary" and falsely equate it with fully distributed costing. It is neither. Proposal One attributes *variable* costs (not all costs), and it does so on the basis of reliably identified causal relationships — indeed, the *same causal relationships* measured by the "distribution keys" that result from the Postal Service's own testing. Proposal One would use those same distribution keys for the same purpose for which they are used today (to identify causal relationships between products and costs), except it would apply them to *all* variable costs, instead of arbitrarily limiting them to marginal costs alone. The conceptual tool known as the Shapley Value further demonstrates the rigor of Proposal One's approach.

Adopting Proposal One will bring greater clarity and transparency to postal costing. It will mean that individual competitive products would bear responsibility for *all* of the variable costs with which they can be reliably identified. The Commission (and the taxpaying public) would finally be able to evaluate whether the tremendous investments the Postal Service is making into competitive products are rational or not. Accordingly, it is incumbent upon the Commission to adopt Proposal One.

In connection with Proposal Two, this docket has also established just how poorly the Postal Service understands the large amount of costs it classifies as "institutional" (nearly $34 billion in FY2015). Traditionally, many have assumed that the Postal Service's "institutional" costs are costs that are both fixed and common to the enterprise. In fact, the Postal Service is currently seeking to justify a larger exigent rate increase for market-dominant products before the D.C. Circuit on the ground that its "institutional costs are largely either *fixed network costs* that cannot be eliminated merely because mail volume declines, or costs associated with congressional mandates that cannot be cut under existing law[.]"[7] In this docket, however, the Postal Service has disclaimed making any effort to determine which of its costs are "fixed"[8] and conceded that large volumes of variable costs (in the form of inframarginal costs) fall within its "institutional" cost category.

Moreover, despite being given ample opportunity, the Postal Service has been unable to identify *any* empirical basis for classifying many cost pools as fixed and, as a result, for not attributing them to products. It is now clear, as Charles McBride first diagnosed in his white paper for the Commission, that these classifications are largely subjective. Picking up on that work, Dr. Neels has shown that this ad hoc approach results in the Postal Service systematically overclassifying costs as fixed (and thus institutional).

Instead of correcting this problem, or even acknowledging it, the Postal Service suggests that existing costing methodologies must be adequate because they have been in place for years. The fact is, these methodologies are not adequate. Recent

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[7] *See* Brief of the United States Postal Service at 8, *U.S. Postal Serv. v. Postal Regulatory Comm'n*, No. 15-1297 (D.C. Cir. Jan. 4, 2016) (brief concerning review of PRC Order No. 2623) (emphasis added); *id.* at 38 (arguing that the exigent rate increase is necessary to make a "contribution toward *the fixed costs* that arise from running a nationwide network that delivers to every address, six days per week") (emphasis added).

[8] *See* Responses of the United States Postal Service to Questions 1-4 of the Chairman's Information Request No. 2 at 12, Dkt. No. 2016-2 (Dec. 10, 2015) ("USPS Response to CHIR 2") (stating that the Postal Service does not "determine which of its costs are fixed").

events only make it more essential that the Postal Service use rigorous, empirically sound cost classification methodologies and that these be transparent.[9] The Commission, the taxpaying public, market-dominant mailers, and others deserve to have a firm financial understanding of the Postal Service's costs and which products cause them so long as the Postal Service enjoys a monopoly over First Class letters and the mailbox.

The Postal Service and Amazon have also engaged a number of economists to criticize Dr. Neels' econometric work. Their criticisms suggest that perfection is the standard by which Dr. Neels' work must be measured, while these same economists fail to apply anything close to that standard to the Postal Service's own cost classification practices. Moreover, as Dr. Neels painstakingly shows in his reply report, submitted herewith,[10] these criticisms fail on the merits. Dr. Neels' proposed solution is the *only* one that improves a status quo in great need of improvement. To be conservative, Dr. Neels has now narrowed his proposed solution to focus only on the 27 components in which his statistically significant findings contradict classifications resting on nothing more than untested assumptions. There is no justification for retaining the current classifications of these components, which are devoid of empirical rigor. Accordingly, Proposal Two should be adopted as well.

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[9] There is simply no defense for the status quo. Market-dominant mailers have posed significant questions as to why their increased participation in workshare programs is not paying off. They have asked the Postal Service to explain irreconcilable differences in rates and for the Postal Service to explain why many cost reduction programs are not working. None of these questions can be effectively answered while so many variable costs that can and should be attributed to products are merely lumped together as institutional costs today.

[10] Reply Report of Dr. Kevin Neels to Accompany UPS Reply Comments in Docket No. RM2016-2 (Mar. 25, 2016) ("Neels Reply").

PROPOSAL ONE[11]

I. PROPOSAL ONE IS CONSISTENT WITH THE PLAIN LANGUAGE AND LEGISLATIVE PURPOSE OF PAEA.

As noted, Congress enacted PAEA to give the Postal Service greater flexibility to price parcels while restraining its ability to leverage the letter monopoly, and the advantages that come with it, to compete unfairly against private sector rivals. As the Senate's Report makes clear, the purpose of the law includes establishing "appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete." S. Rep. No. 108-318 at 14 (2004). The House Report similarly provides that, under the Act, "the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors, albeit with stronger controls, oversight, and limitations in recognition of its governmental status." H.R. Rep. No. 109-66 at 44 (2005).

The legislative history of PAEA thus evinces Congress' broad purpose of establishing appropriate safeguards, controls, and oversight to ensure that the Postal Service competes on a level playing field against private sector rivals in parcel markets. As noted, to accomplish that purpose, Congress specifically mandated that the Postal Service must prove to the Commission that "each competitive product" it sells generates revenues sufficient to "cover[] its costs attributable," 39 U.S.C. § 3633(a)(2), defined to include all "direct and indirect postal costs attributable . . . through reliably identified causal relationships," 39 U.S.C. § 3631(b).

[11] Sections I through IV principally relate to Proposal One's impact on the "costs attributable" to individual competitive products under 39 U.S.C. § 3633(a)(2). Section V relates to the "subsidization" test of § 3633(a)(1).

Despite the clarity of the statutory command and the purpose of the Act, the Postal Service's cost attribution practices remain woefully deficient. The Postal Service has now acknowledged that, since PAEA was passed, it has not attributed a single dollar of indirect postal costs, including inframarginal costs, to a single competitive product.[12] Neither the Postal Service nor Amazon, nor their experts, can reconcile their extremely narrow positions on cost attribution with the plain language of PAEA or its legislative purpose.

A. The Narrow Positions of the Postal Service and Amazon are Inconsistent with PAEA's Plain Language.

The positions advanced by the Postal Service and Amazon are at odds with the plain language of § 3633(a)(2). The Postal Service and Amazon argue that inframarginal costs cannot be attributed to products because those costs are not *directly and exclusively* caused by a single product. *See* Initial Comments of the United States Postal Service on Proposals One and Two at 13, Dkt. No. RM2016-2 (Jan. 25, 2016) ("Postal Service Comments"); Initial Comments of Amazon Fulfillment Services Inc. at 80-81, Dkt. No. RM2016-2 (Jan. 25, 2016) ("Amazon Comments"). They argue that the

[12] In its response to CHIR 2, the Postal Service originally asserted that it "*has attributed inframarginal costs to products* in the only instance in which there is a reliably identified causal relationship between those inframarginal costs and the products that caused them." USPS Response to CHIR 2 at 7. As it later acknowledged, however, it has not attributed *any* inframarginal costs to *any* products since PAEA was passed. *See* Responses of the United States Postal Service to Questions 1-3 of Chairman's Information Request No. 7, Dkt. No. RM2016-2 (Mar. 2, 2016) ("USPS Response to CHIR 7").

only costs that can be attributed to products are marginal or incremental costs because only those cost categories are directly and exclusively caused by a single product.[13]

This argument makes two related errors. *First*, Congress did *not* limit "costs attributable" to costs *directly and exclusively* caused by a single product. Instead, Congress defined "costs attributable" more broadly to include "the direct and indirect postal costs attributable . . . through reliably identified causal relationships." 39 U.S.C. § 3631(b). That is, Congress defined "attributable costs" to embrace attribution of costs that are, to some degree, common to multiple products.

The plain meaning of "indirect costs" includes costs not caused solely by a single product. For instance, the federal Cost Accounting Standards define "indirect costs" as "any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective." 48 C.F.R. § 9904.418-30(a)(3). Leading accounting treatises similarly define "indirect costs" as costs that "cannot be directly traced to units produced or cost objects precisely because such costs are incurred in providing benefits to several different product lines or users." Jerold Zimmerman, *Accounting for Decision Making and Control* 336 (McGraw-Hill/Irwin 2010); *see also* Ray Garrison *et al.*, *Managerial Accounting* 51 (McGraw-Hill Education 2014) ("An indirect cost is a cost that cannot be easily and conveniently traced to a specific cost object"); *see also* Black's Law Dictionary (10th ed. 2014) (defining indirect

[13] Various other commenters join in this argument. *See, e.g.*, Comments of Market Dominant Mailers at 10-12, Dkt. No. RM2016-2 (Jan. 25, 2016) ("Market Dominant Mailers").

cost as "[a] cost that is not specific to the production of a particular good or service but that arises from production activity in general, . . .").[14]

The legislative history to PAEA's predecessor act, the Postal Reorganization Act ("PRA"), which first used the phrase "direct and indirect costs," confirms this interpretation. 39 U.S.C. § 3622(b)(3) (amended in 2006). In PRA, Congress intended "indirect costs" to have the meaning ascribed to the term by the report of the President's Commission on Postal Organization (Kappel Commission), which defined the term as "[t]hose elements of cost which cannot unequivocally be associated with a particular output or product." *Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Serv.*, 462 U.S. 810, 827 n.21 (1983) ("*NAGCP IV*") (quoting Kappel Commission, Toward Postal Excellence: The Report of the President's Commission on Postal Organization Annex (1968)).

Thus, indirect postal costs, which Congress defined to be part of "costs attributable" in PAEA, are costs that *can* be attributed to products despite not being directly, exclusively, or unequivocally caused by a single product. This fact alone is fatal to the narrow Postal Service and Amazon positions about cost attribution, which impermissibly read "indirect postal costs" out of the statute.[15] It also necessarily means

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[14] These definitions guide the interpretation of "indirect costs" here. *See Marymount Hosp., Inc. v. Shalala*, 19 F.3d 658, 662 (D.C. Cir. 1994) (relying on regulations not "strictly applicable" to identify "a principle that should be used to define . . . costs" in a different context); *City of Dallas, Tex. v. F.C.C.*, 118 F.3d 393, 395 (5th Cir. 1997) ("Dictionary definitions, industry practice, and accounting standards are prime sources for the court to determine congressional intent.").

[15] *See Air Line Pilots Ass'n Int'l v. Pension Benefit Guar. Corp.*, 193 F. Supp. 2d 209, 218 (D.D.C. 2002) ("It is a well-established principle that when interpreting statutes . . . a court should . . . read the statute or provision so that no word, clause, sentence, or phrase is rendered surplusage, superfluous, meaningless or nugatory.") (quotation marks and citation omitted).

that the current practice (which, by design, attributes *no* indirect postal costs to *any* product) is arbitrary and capricious.[16]

Second, the Postal Service and Amazon misstate the applicable causation standard. The causation standard applied in PAEA is not sole or exclusive causation. "Reliably identified," as used in § 3631(b), does not denote sole or exclusive causation. As a legal matter, something can be reliably identified as a cause of something else when it is a substantial contributing factor, even if it is not the *sole* or *exclusive* cause.[17]

In fact, the D.C. Circuit has expressly recognized that PAEA embraces broader principles of causation than exclusive causation. *See U.S. Postal Serv. v. Postal Regulatory Comm'n*, 640 F.3d 1263, 1264 (D.C. Cir. 2011) (holding that the phrase "due to" in 39 U.S.C. § 3622(d)(1)(E) is a causation standard embracing multiple causation). According to the D.C. Circuit, "[i]t would not be incorrect to say that the requested rate increase is 'due to'" an extraordinary factor (as required by the statute) "simply because it is also 'due to' other factors as well." *Id.* For example, the Circuit explained, "[a] financial crisis can often result from multiple contributing factors, of which only one may be 'extraordinary or exceptional.'" *Id.*[18]

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[16] *See Illinois Pub. Telecommunications Ass'n v. F.C.C.*, 117 F.3d 555, 566 (D.C. Cir. 1997) (holding that commission regulation that "appears to be blatantly inconsistent with the language of the statute" was "arbitrary and capricious"), *decision clarified on reh'g*, 123 F.3d 693 (D.C. Cir. 1997); *Indep. U.S. Tanker Owners Comm. v. Dole*, 809 F.2d 847, 854 (D.C. Cir. 1987) (holding that "failure to link the policies served by this rule to the objectives set out in the [statute]" was "arbitrary and capricious").

[17] *See, e.g., Rainbow Tours, Inc. v. Hawaii Joint Council of Teamsters*, 704 F.2d 1443, 1448 (9th Cir. 1983) (citing *Mead v. Retail Clerks Int'l Ass'n, Local Union No. 839, AFL-CIO*, 523 F.2d 1371, 1374 (9th Cir. 1975)) (noting that under the antitrust laws, which incorporate "[g]eneral tort principles," "substantial cause" means "a materially contributing factor" not the "sole" or even "predominate" cause).

[18] Amazon, in fact, acknowledges that postal regulations embrace a broader causation standard. For example, in describing R77-1, the first omnibus rate case after

That same principle applies here: an inframarginal cost can be reliably identified with a particular class of products, even if those products are not the *sole* or *exclusive* cause of the cost. That conclusion is consistent with the Commission's own recognition that inframarginal costs are variable costs that are causally related to product volume, as measured in cost drivers, and thus can be included in the direct cost of a product.[19]

B. Proposal One Attributes Variable Costs to Products Through Reliably Identified Causal Relationships.

In contrast to the status quo, and to the Postal Service and Amazon positions, Proposal One does just what Congress said in § 3633(a)(2) *must* happen: it attributes to competitive products all direct and indirect postal costs that can be attributed through reliably identified causal relationships. In fact, Proposal One uses the same mechanisms to identify these causal relationships that the Postal Service has developed for this very purpose.[20]

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the first decision in *Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Serv.*, Amazon notes the underlying "economic principle that cost attribution should require *some showing* of causation." Amazon Comments at 46 (emphasis added). Valpak recognizes in its comments that "the cost methodology incorporated in UPS Proposal One . . . appears to meet the economic standard for causality." Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.'s Initial Comments on United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies at 20, Dkt. No. RM2016-2 (Jan. 27, 2016) ("Valpak Comments").

[19] *See* Solicitation No. PRC-2014-2, RFP re: Study of Postal Service Institutional Cost at 4 (May 22, 2014) ("Commission RFP") ("[Inframarginal] costs are causally related to volume and, in total, increase or decrease as volume increases or decreases."); *id.* (noting that, because inframarginal costs are variable costs, "these costs can be included in the direct cost of a product"); *id.* at 18 ("[T]he total amount of inframarginal cost in a component is directly related to the total amount of the cost driver(s) of a component . . . .").

[20] *See* Public Representative Comments at 26, Dkt. No. RM2016-2 (Jan. 27, 2016) ("T]he evidence for causality of inframarginal costs is identical to the currently accepted evidence that volume variable costs are causally related to products."); *id.* at 25 (agreeing "that inframarginal costs can be determined, calculated and attributed to products").

Specifically, Proposal One uses the cost drivers identified by the Postal Service for each cost component or subcomponent and the applicable distribution keys developed by the Postal Service to determine which individual products are responsible for which portions of variable costs. The sum of those attributed portions across all the components yields the total attributable cost for each product. This method of cost attribution is grounded in the actual data and the causal relationships identified by the Postal Service.

In many components, Proposal One's attribution of variable costs to products is straightforward. For example, within the purchased highway transportation component (component 143) the cost driver for inter-Section Center Facility ("SCF") transportation is cubic foot-miles. The Transportation Cost System samples inter-SCF movements and calculates the distribution of cubic foot-miles by product. The Postal Service calculates the share of so-called "volume variable" (*i.e.*, marginal) costs attributable to each product based on the share of cubic foot-miles taken up by each product. Proposal One would attribute inframarginal costs in the same manner.

Proposal One works similarly in more complex cost components. For example, Proposal One would also attribute costs of city carrier street time to products using the causal relationships identified in the applicable costing model — which, as of today, is the model developed in Proposal Thirteen in the City Carrier Street Time docket. *See Report on the City Carrier Street Time Study*, Dkt. No. RM2015-7 (Dec. 11, 2014). The output of that model is effectively a set of "volume variable" costs for each of a number of mail streams, such as "Cased Mail" or "Deviation Parcel Deliveries." The City Carrier Costing System estimates, for each of these mail streams, the proportion of pieces associated with each postal product. These shares form the distribution keys the Postal Service uses to divide up what it considers attributable costs within the respective components. For example, using 2013 data, Proposal Thirteen calculated that Single-Piece Letters caused attributable costs of $1,276,415,000 out of a total of $7,402,029,000, or approximately 17.2%. *See* United Parcel Service Comments Attaching Supplemental Report Related to Proposal Thirteen, Report of Dr. Neels at 41, Dkt. No. RM2015-7 (June 8, 2015). That result, coupled with similar computations for other Postal products, yields a weighted distribution of attributable costs to products (*i.e.*, the distribution keys).

Proposal One would use those same distribution keys for the same purpose, except it would use them to attribute *all* variable city carrier street time to products, instead of limiting attribution to marginal costs only. Doing so would mean that individual competitive products would finally bear responsibility for *all* of the variable costs with which they are reliably identified. As a result, Proposal One is far superior to the very constricted approach to cost attribution the Postal Service uses today.

Dr. Bradley offers up "the time spent by a mail carrier on his delivery route" as an "excellent example" of how cost attribution works under the status quo, even while acknowledging that, since a mail carrier delivers more than one type of mail product, the Postal Service does not attribute *any* of these costs to *"to any individual product."* Bradley at 3 (emphasis added). Instead, these costs are lumped in with all the other institutional costs to be borne largely by market-dominant mailers. This outcome is unfair and unacceptable. The fact that a postal carrier delivers more than one product should not excuse the Postal Service from attributing *any* of the time spent on a mail carrier's delivery route to *any* of its products.

Proposal One shows how the Postal Service can do better. As Dr. Neels explains, multi-product firms are not nearly as unable to attribute costs as Dr. Bradley suggests. Dr. Bradley argues that average variable cost in the context of a multi-product firm "has no meaning, because it combines diverse products . . ." Bradley at 10. But he fails to recognize that attributing variable costs through the use of distribution keys is analogous to attributing average variable cost in a single-product enterprise (which he acknowledges is appropriate). Distribution keys provide a way to compare different product lines in a meaningful way — indeed, that is their primary purpose. Once those different product lines are treated as fungible units of the same cost driver using the distribution keys, one can readily compute average cost per unit of cost driver, and hence average cost per unit of product. In this way, the average variable cost, or cost per unit of cost driver, provides a reliable way to attribute cost drivers among multiple products.[21] *See* Neels Reply at 11-12.

The current distribution keys, like other aspects of Postal costing, warrant ongoing review, and UPS supports this ongoing review. But, if chosen properly, they clearly can be used to attribute costs based on reliably identified causal relationships between individual products and established cost drivers. *See* Amazon Comments at 84 (acknowledging that distribution keys "are properly used to attribute costs" when "(1)

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[21] For example, if the cost driver in a particular segment is cubic volume, and a "First-Class Parcel" takes up ten cubic inches while a "High Density Letter" takes up one cubic inch, each unit of "First-Class Parcel" should have ten times the cost attributed to it relative to a unit of "High Density Letter." In this example, if the cost per unit volume is $0.50 per cubic inch, the relevant average cost for a "First Class Parcel" is $5.00, while the relevant average cost for a "High Density Letter" is $0.50.

the distribution keys are valid and (2) the component variability factor is correct"). That is the purpose they serve today, and it would continue to be their role in Proposal One.

C. The Criticisms of Proposal One's Cost Attribution Methodology are Meritless.

The Postal Service and Amazon fail to identify any way in which Proposal One is inconsistent with the statutory command of § 3633(a)(2). For the most part, their criticisms simply repeat their mistaken premise that the only costs that can possibly be attributed are marginal or incremental costs.

The Postal Service and Amazon repeatedly assert, for example, that Proposal One's method of cost attribution is "arbitrary." *See, e.g.*, Postal Service Comments at 13; Amazon Comments at 79. But this assertion is entirely circular. Since their experts have (incorrectly) *defined* the costs that can have a causal relationship to products to be limited to marginal or incremental costs, any approach that attributes any other costs is necessarily "arbitrary" in their view. Their claim that Proposal One is arbitrary simply repeats the mistaken premise that cost causation under PAEA is limited to marginal or incremental costs.[22]

The Postal Service and Amazon have done nothing to establish that Proposal One is arbitrary in any meaningful sense of the term. In fact, as Dr. Neels explains, "[o]ne cannot question the suitability of using cost driver units to distribute inframarginal

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[22] Amazon also argues that Proposal One is flawed because it uses the distribution keys to attribute inframarginal costs without an "underlying causal link." *See* Amazon Comments at 84. But, again, this argument is premised on Amazon's mistaken assumption that the causation standard in § 3633(a)(2) is limited to direct and exclusive causation and that only incremental costs qualify. The Market Dominant Mailers' argument that, notwithstanding Congress' use of the phrase "indirect cost," inframarginal costs cannot be attributed because they are not "avoided by eliminating a given increment of output" rests on the same mistaken premise. Market Dominant Mailers at 12.

costs without simultaneously calling into question their suitability for attributing volume variable costs." Neels Reply at 13. Moreover, as discussed further below, the precision of the cost attribution methodology used by Proposal One is confirmed by application of the Shapley Value. If anything is "arbitrary," it is the status quo approach which allows the Postal Service to stop cost attribution at marginal cost.

The Postal Service and Amazon also claim that Proposal One relies on "extended inference" or "aprioristic" accounting definitions to attribute costs to products, Postal Service Comments at 7; Amazon Comments at 49, without identifying what those supposed inferences or "aprioristic" accounting definitions are. In fact, Proposal One is grounded in the real world and utilizes the Postal Service's existing costing machinery to determine which portion of variable costs are caused by which products.

Any costing model necessarily represents a more complex underlying reality. For example, in its analysis of city carrier costs the Postal Service employed a quadratic polynomial equation because it believed this flexible form could approximate the actual underlying cost relationships. Proposal One is not unique in that regard.

The Postal Service and Amazon also wrongly assert that Proposal One amounts to "fully distributed" or "fully allocated" costing approaches, approaches which they claim have been "severely criticized by economists." *See* Amazon Comments at 30.[23] Proposal One is not fully distributed or fully allocated costing. As Amazon acknowledges, those approaches use accounting assumptions to allocate *all costs*, including "*the fixed and common costs of the firm as a whole.*" Amazon Comments at

[23] *See also* Initial Comments of the American Catalog Mailers Association at 27, Dkt. No. RM2016-2 (Jan. 27, 2016) ("ACMA Comments") ("That is, regardless of the shape of the curves, full distribution of component costs to products is required. Neels's interest in FDC is unabashedly clear").

29 (emphasis added). Proposal One does not attribute all costs, and it specifically does not allocate tens of billions of dollars of fixed and common costs of the enterprise as a whole (that is, those costs properly considered "institutional"). Instead, Proposal One attributes to products only those *variable* costs that are caused by products and affected by product volume (in addition to the small amount of product-specific fixed costs attributable today).[24]

It is worth noting, however, that some regulators have found fully distributed costing to be appropriate to address specific regulatory problems. In fact, the European Parliament, guided by some of the same concerns facing Congress in PAEA, issued a directive requiring postal operators to fully distribute costs to products — including direct and indirect costs *and* the remaining unattributed common costs.[25] Other regulators have made similar choices.[26]

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[24] Amazon and the Market Dominant Mailers creatively argue that Proposal One is fully distributed costing because it attributes all costs in those components that are fully variable. *See* Amazon Comments at 14; Market Dominant Mailers at 3 ("For cost components that are estimated to have no fixed costs, the costs assigned by Proposal One would equal fully distributed costs"). By this circular argument, all cost attribution approaches (including the status quo) are fully distributed costing because they attribute all costs in components composed solely of the costs the approaches attribute. So, for example, the status quo is fully distributed costing because it attributes all costs in components composed of "volume variable" costs.

[25] *See* Petition of United Parcel Service, Inc. for the Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies at 17-18, Dkt. No. RM2016-2 (Oct. 8, 2015) ("Petition") (citing Directive of the European Parliament and of the Council amending Directive 97/67/EC, Concerning the Full Accomplishment of the Internal Market of Community Postal Services at 14 (2006)).

[26] *See, e.g.,* Colorado Revised Statutes, 47 C.R.S. § 40-3-104.3 (requiring use of fully distributed cost methodology to develop rates for off tariff gas, electric and steam contracts); Kentucky Revised Statutes, K.R.S. § 278.2203 (requiring utilities engaging in unregulated activities to employ a fully distributed cost method or alternative SEC, FERC or USDA method to allocate costs between regulated and unregulated activities); Iowa Administrative Code, 199 IAC § 31.7 (requiring fully distributed cost pricing in transactions between a utility and its unregulated affiliates).

In contrast, neither the Postal Service nor Amazon has cited a regulatory body faced with a comparable situation here — a massive, state-owned enterprise with a legally protected monopoly over one set of products that is seeking to use its monopoly-protected network to expand aggressively into unregulated markets — that allowed the monopolist to attribute only marginal costs to the products sold in competitive markets. This highlights the truly radical nature of the Postal Service's practice of attributing only marginal costs to competitive products.

D. Proposal One Furthers PAEA's Legislative Purpose, While the Status Quo Does Not.

Proposal One also furthers the legislative purpose of PAEA. The status quo, and the Postal Service and Amazon positions, on the other hand, would directly frustrate the legislative purpose and must be rejected as a result.[27]

i. Proposal One Is Necessary to Prevent the Postal Service from Using Advantages Arising from the Letter Monopoly to Undercut Equally Efficient Private Competitors.

As noted, the main purpose of § 3633(a)(2) is to provide appropriate oversight to ensure that that the Postal Service competes on a level playing field with private sector companies in markets for parcels and other competitive products. Congress was concerned about allowing the Postal Service to leverage the same network built for and protected by the letter monopoly to gain advantages over private sector rivals that those

[27] *See Wagner v. Fed. Election Comm'n*, 717 F.3d 1007, 1013 (D.C. Cir. 2013) (quoting *Chapman v. Houston Welfare Rights Org.*, 441 U.S. 600, 608 (1979)) ("As in all cases of statutory construction, our task is to interpret the words of . . . statutes in light of the purposes Congress sought to serve."); *United States v. Barnes*, 295 F.3d 1354, 1364 (D.C. Cir. 2002) ("A statute should ordinarily be read to effectuate its purposes rather than frustrate them.") (citation omitted); *Shapiro v. United States*, 335 U.S. 1, 31 (1948) (noting the "well-settled doctrine" of reading "a statute . . . susceptible of either of two opposed interpretations[] in the manner which effectuates rather than frustrates the major purpose of the legislative draftsmen").

rivals could never overcome, no matter how efficiently they operate. *Each and every* report in PAEA's legislative history makes clear that this concern animated § 3633(a), including the cost attribution requirement of § 3633(a)(2).[28] Congress judged these requirements necessary to "ensure that the Postal Service competes fairly with the private sector, particularly when offering products and services classified as competitive. . . ." S. Rep. No. 108-318 at 27 (2004).

Congress' concern can be seen visually in the following figures. Suppose that the Postal Service and a private competitor are equally efficient. At any given level of production, the two entities will have identical marginal costs. But now suppose in Figure 1 that the Postal Service has substantial volume deriving from the letter monopoly and a moderate amount of volume deriving from competitive products. As Figure 1 demonstrates, the Postal Service's costing model would estimate *marginal*

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[28] *See* H.R. Rep. No. 109-66 at 44 (2005) ("Under [39 U.S.C. § 3633], the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors, albeit with stronger controls, oversight, and limitations in recognition of its governmental status."); *id.* at 53 (noting Congress' "intent . . . to level the playing field for the Postal Service and its competitors in the Competitive product market. . . ."); S. Rep. No. 108-318 at 27 (2004) (explaining that PAEA is "necessary to ensure that the Postal Service competes fairly with the private sector, particularly when offering products and services classified as competitive. . . ."); *id.* at 28 (noting the importance of taking steps "to level the playing field between the Postal Service and its competitors" since PAEA "gives the Postal Service significant new commercial flexibilities, particularly in the area of pricing"); *id.* at 15 (PAEA's requirement "that all competitive products collectively cover their share of the Postal Service's institutional costs" was "intended to ensure that the Postal Service competes fairly in the provision of competitive products."); *id.* at 14 (explaining that PAEA creates "appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete"); H.R. Rep. No. 108-672 at 3-4 (2004) ("Under the legislation, the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors, albeit with stronger controls, oversight, and limitations in recognition of its governmental status.").

costs for competitive products at the far right of the costing curve — that is, the purple rectangle.

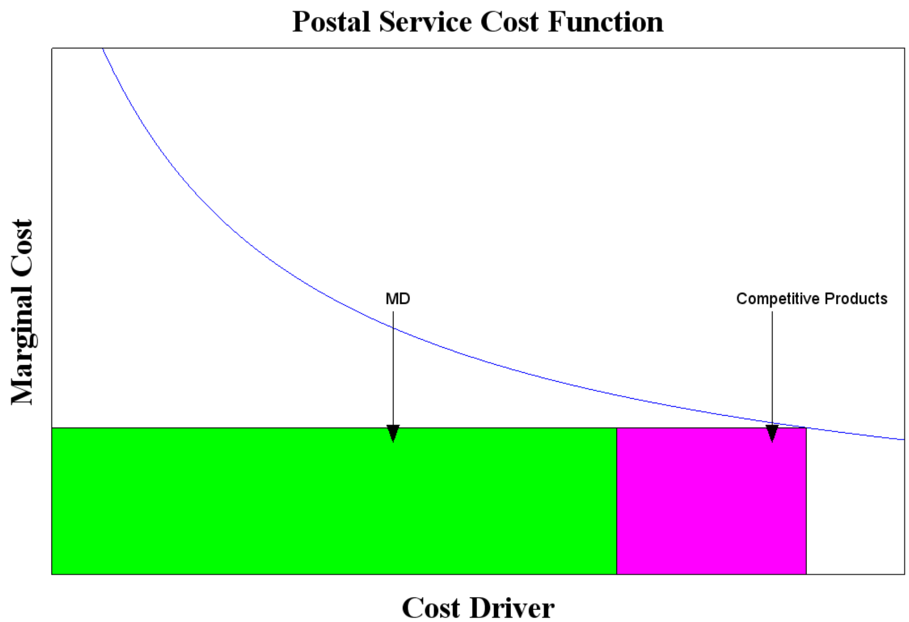

Figure 1: Postal Service Cost Function

If the Postal Service were to attribute only marginal costs to its competitive products, then its competitive products will have low attributable costs for no other reason than that the Postal Service produces a large volume of products protected by the letter monopoly. Meanwhile, the more expensive variable costs, occurring earlier on the curve, will either have to be recovered by market-dominant products or not recovered at all.

Now consider a private sector competitor that (1) operates on an *equally efficient* basis, and thus on the *same* cost curve, and (2) produces the *same volume* of competitive products as the Postal Service. At any given total volume (*i.e.*, combined market dominant and competitive volume) this hypothetical competitor and the Postal Service would have the same marginal costs, as the two are equally efficient. As Figure

2 demonstrates, however, lacking the volume associated with monopoly products the hypothetical private sector competitor would be forced to operate far leftwards on the cost curve, at a higher cost of production, *and* the competitor would have to recover *all* of its variable costs in order to stay in business. It would thus have to recover the full purple shape in the following figure.

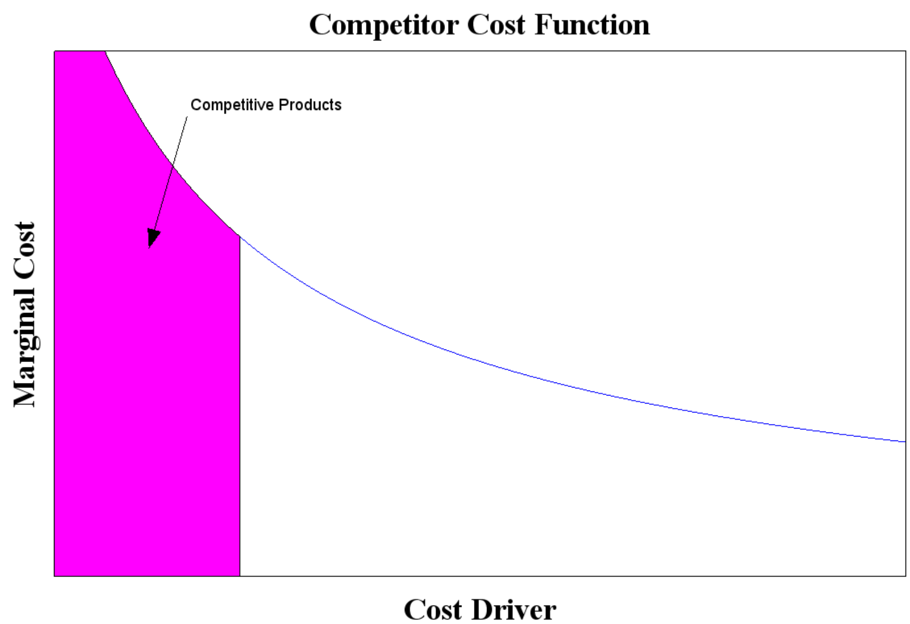

Figure 2: Competitor Cost Function

This contrast in cost coverage between the Postal Service and an equally efficient private competitor shows the tremendous advantages given to the Postal Service by a costing methodology that lets the Postal Service attribute only marginal costs to competitive products. These advantages do not arise from the Postal Service being a better or more efficient competitor. They arise simply because it is allowed to attribute costs based solely on the estimated marginal cost of the last unit.

Proposal One addresses this problem by placing the Postal Service on a level playing field with equally efficient private sector rivals, as Congress intended. Just like those rivals, the Postal Service must generate revenues sufficient to cover *all* of the variable costs that are caused by, and attributable to, its competitive products.

The Postal Service and Amazon barely acknowledge this concern, suggesting that they believe Congress' insistence that the Postal Service compete on a level playing field in parcel markets is a trivial concern the Commission is free to disregard when implementing § 3633(a)(2). This suggestion is deeply mistaken. Congress' commitment to ensuring that vigorous private sector competition is not swept aside by a dominant, state-owned enterprise reflects a principled and long-standing Congressional preference for free markets and private competition over governmental monopolies. And it reflects a preference for competition among private sector companies as the primary engine of the American economy. There is nothing trivial about that commitment.

As Dr. Neels explains, there are reasons to be concerned that the Postal Service might pursue expansion in parcel markets without regard to whether that expansion is profitable. *See* Neels Reply at 5-6. Moreover, ample literature establishes that replacing private competition with dominance by a state-owned enterprise yields a host of inefficiencies in the long run.[29] In market after market, and with rare exception,

[29] *See, e.g.,* Cohen *et al.*, *Universal Service Without a Monopoly* at 1 (Nov. 1999), http://www.prc.gov/sites/default/files/papers/universalservice.pdf ("The opportunity costs of monopolies are now well understood. Telephone, airline and trucking deregulation has led to such innovations, real price declines and job growth that they have received much credit for recent US. economic growth. With its extension to the electric and natural gas industries, deregulation has become the norm in the U.S. economy. The Postal Service remains one of the last de jure monopolies."); Cohen *et al.*, *An Analysis of the Potential for Cream Skimming in the U.S. Residential Delivery Market* at 2 (Oct. 1998), http://www.prc.gov/sites/default/files/papers/cohen_0.pdf ("Postal monopolies, like most other legal monopolies, are thought by many observers to be technically inefficient").

legislators and regulators have chosen robust free-market competition over giving the market to a single provider entity. PAEA reflects Congress' intention to maintain robust private sector competition in markets that are not subject to the letter monopoly. That intention must be respected, and Proposal One does so.

ii. <u>The Status Quo and the Postal Service and Amazon Positions Directly Frustrate the Legislative Purpose of PAEA</u>**.**

Unlike Proposal One, the status quo and the Postal Service and Amazon positions advanced in this docket are not tethered to Congress' purpose in enacting PAEA. Instead, the Postal Service and Amazon repeat narrow positions on cost attribution that their economists have advanced for decades, well before PAEA was even considered. As noted above, they assert that only marginal or incremental costs (which, as calculated at the individual product level, are similar) can possibly be attributed to products. They maintain that Drs. Bradley and Panzar resolved the issue of cost attribution, once and forever, decades *before* the Postal Service sought to expand aggressively into parcel markets and *before* Congress created the category of competitive products in PAEA and subjected them to oversight.

To explain the fact that their economists are providing the same old answers to the new circumstances Congress addressed in PAEA, the Postal Service and Amazon implausibly assert that PAEA did not address any significant new issues regarding competitive products. *See, e.g.*, Amazon Comments at 55 (asserting Congress did not intend to make "any major change" in PAEA). But Congress itself described the attribution of costs to competitive products following PAEA as "*especially important*" in light of the fact that the legislation gave "the Postal Service significant new commercial flexibilities, particularly in the area of pricing" for competitive products.[30]

The problem is not just that the Postal Service and Amazon disregard Congress' central purpose in enacting § 3633(a)(2). The greater problem is that the positions they advance would directly frustrate that purpose. Indeed, the one time he expressly acknowledges Congress' level-playing-field concern, Dr. Panzar offers an entirely unpersuasive attempt to reconcile his position with it. Notably, he first agrees that, if the Postal Service's competitive products are allowed to disregard large volumes of variable costs, such as inframarginal costs, then the Postal Service would have "an unfair advantage over its rivals." Panzar at 14. But he asserts an incremental cost price floor "prevents" this outcome "because prices that satisfy the incremental cost test ensure that neither the *customers* of the enterprise's other services nor *the enterprise itself* are made worse off by the fact that the competitive services are offered." *Id.* (emphasis added).

This argument is a non sequitur: Congress is concerned about the Postal Service having an "unfair advantage" over *private sector rivals*, who cannot simply disregard their more expensive variable costs (or shift them to monopoly-protected products). The fact that the incremental cost test supposedly protects (in the short

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[30] S. Rep. No. 108-318 at 27 (emphasis added); *see also* Charles McBride, *Calculation of Postal Inframarginal Costs* 3 (2014) ("McBride") ("In 2006, the postal regulatory landscape was changed dramatically by the passage of the Postal Accountability and Enhancement Act."); Public Representative Comments at 24 (recognizing that PAEA "increased the need for the Commission to ensure products cover their . . . attributable costs based on reliably identified cost relationships.").

term) customers or the enterprise itself is irrelevant to its unfair advantage under the status quo *over private sector rivals*.[31]

In fact, as noted above, Dr. Panzar proceeds to demonstrate that, to the extent the letter monopoly allows the Postal Service to have a lower marginal cost than private sector rivals, the theoretical result is that the Postal Service will become the *sole provider* of the product and services over which it competes with private sector rivals, eventually yielding a "*monopoly industry configuration*," *id.* at 27 (emphasis added), where the Postal Service is the dominant provider of both market-dominant products and parcels.

Dr. Panzar is untroubled by this result because he believes it is "efficient." *Id.* But this is only because his concept of "efficiency" is limited to short-run static efficiency, a narrow focus which Congress did not share. Congress' concern about ensuring that competition occurs on a level playing field in parcel markets strongly indicates a concern for promoting *dynamic* efficiency.[32] As Dr. Neels explains, as a result of this

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[31] Dr. Panzar's position also conflates § 3633(a)(1), which prohibits "subsidization of competitive products by market-dominant products," and § 3633(a)(2), which requires each competitive product to recover its "costs attributable." In Dr. Panzar's narrow view, the only concern that matters is "cross-subsidization," which he believes is addressed by the incremental cost test. But, if this were Congress' only concern, there would have been no need for Congress to impose the separate requirement of § 3633(a)(2). Dr. Panzar misses that this latter section was intended to address a distinct (albeit related) concern: ensuring that the Postal Service compete against private sector parcel companies on a level playing field. As a consequence, his positions fail to take account of this concern at all.

[32] The comments of certain mailers in this docket also mistakenly assume that Congress' sole goal in § 3633 was to ensure the Postal Service sets "efficient" prices, with efficiency construed as short-run static efficiency. *See* ACMA Comments at 2 ("The existing costing system is rooted in our understanding of economic efficiency and consumer welfare"); *id.* at 3 ("This balance makes marginal-cost prices efficient, which is the reason there is widespread agreement that marginal costs are the key cost of relevancy for ratesetting.").

narrow focus, Drs. Panzar and Bradley "fail to acknowledge the customer benefits provided by vigorous private sector competition and role it plays in assuring dynamic efficiency and innovation[.]" Neels Reply at 2.[33]

Dr. Bradley's effort to address Congress' level-playing-field concern is similarly unpersuasive. He argues that, "using marginal costs as a starting point for pricing provides no unfair advantage for the Postal Service as all firms, could (and should) start their pricing exercises with marginal costs." Bradley at 30. But this ignores the unfair advantage conferred by the letter monopoly which leads to marginal cost levels an *equally efficient private sector competitor* cannot match. Moreover, if the only purpose of § 3633(a)(2) were to tell Postal Service managers where to "start their pricing exercises," as Dr. Bradley suggests, then there would have been little purpose for the section at all (since Dr. Bradley believes any rational business would naturally do this). His disregard of Congress' level-playing-field mandate leads him to fundamentally misunderstand what § 3633(a)(2) is meant to accomplish.

Congress did not enact § 3633(a)(2) to help Postal Service managers "make informed pricing decisions." *Id.* at 21. Congress enacted this provision to provide oversight sufficient to ensure that each and every competitive product generates sufficient revenues to cover all direct and indirect costs attributable to it (*i.e.*, the same costs that private sector competitors must cover), in order to make sure the Postal Service is competing fairly in parcel markets. The Postal Service and Amazon are

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[33] Dr. Neels also explains that Drs. Panzar and Bradley also mistakenly assume that the Postal Service has a perfect and accurate understanding of its cost structure. *See* Neels Reply at 3.

simply unable to reconcile the status quo or their positions with this clear legislative purpose.

II. PROPOSAL ONE IS SUPPORTED BY INSIGHTS FROM THE SHAPLEY VALUE AND THE EXPERIENCE OF OTHER REGULATORS.

The Shapley Value, which has many potential applications to postal costing, shows that the method by which Proposal One attributes costs using the cost drivers and distribution keys is economically rigorous. As Dr. Neels has shown, the cost attribution approach of Proposal One yields results that are essentially equivalent to the direct application of the Shapley Value itself.[34]

The Shapley Value methodology calculates the average of the cost that a firm would incur from adding a given product line across every possible sequence in which the firm could add its various product lines. In this way, the Shapley Value methodology avoids bias with respect to the order in which the firm adds its product lines and ensures each competitive product bears a proportionate share of any cost it causes jointly with other products.[35] The Shapley Value, therefore, provides compelling theoretical support for the straightforward method of variable cost attribution utilized by Proposal One.

The Postal Service and Amazon argue that the Shapley Value cannot be used to determine the *existence* of causal relationships between costs and products. *See, e.g.*,

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[34] *See* Report of Dr. Kevin Neels Concerning UPS Proposals One, Two, and Three at 28, Dk. No. RM2016-2 (Oct. 8, 2015) ("Neels Report") ("We thus arrive at the simple, straightforward and reasonable result that the implementation of the Shapley value approach to the assignment of inframarginal costs to products is equivalent to assigning inframarginal costs using the same distribution keys (whether explicit or implicit) used to assign volume variable costs.").

[35] As Dr. Neels explains in his report, the Shapley Value can be calculated at different levels of granularity. Dr. Neels' approach defines each unit of the cost driver as the unit of analysis, which allows for a mathematical simplification of the exercise and generates Shapley Values that are robust to definitional changes in products. *See* Neels Reply at 3.

Postal Service Comments at 15 ("Shapley values are just one of an infinite number of possible allocations of common costs"); Amazon Comments at 17 ("The record contains no evidence that Shapley-based rates would comply with the bright-line standards of PAEA, including causation requirements of the price floors."). This criticism mistakes the relevance of Shapley to Proposal One.

Proposal One does not use the Shapley Value to identify the causal relationships between competitive products and variable costs.[36] As discussed above, the causal relationships between the applicable cost drivers and variable costs are identified by the distribution keys already used by the Postal Service, independent of the Shapley Value. Proposal One attributes variable costs by applying the distribution keys and cost drivers applicable to each cost component. The Shapley Value confirms the precision and rigor of this approach.[37]

UPS has also shown that the cost attribution methodology used by the Surface Transportation Board ("STB") is consistent in some respects with the approach of Proposal One.[38] The applicable STB statute calls for identification of costs that are "associated with particular movements of goods" and requires a causal relationship

[36] UPS believes the Shapley Value has promise as a direct source of costing standards for postal products, and that is something the Commission may choose to consider in the future.

[37] The Postal Service and Amazon argue that Proposal One should be denied because few if any *other* regulators addressing *different* regulatory issues have chosen *directly* to apply the Shapley Values to attribute costs to products. This argument operates from the premise that the Commission should make its decision in this docket by tallying up how many other regulators have selected the competing proposals in different regulatory contexts. The Commission should instead make its decision based upon which approach is more faithful to Congress' goals and mandates as expressed in the statute that governs here — PAEA.

[38] *See* United Parcel Service, Inc.'s Response to Chairman's Information Request No. 4 at 6-9, Dkt. No. RM2016-2 (Dec. 17, 2015).

between the relevant cost and the goods that cause it, while recognizing that *all variable costs* meet this standard. While the Postal Service and Amazon assert that the STB statute had a different regulatory purpose, the key point is simply that another regulator concluded that a causation standard similar to the one articulated in PAEA embraces attribution of *all* variable costs to products.

III. INFRAMARGINAL COSTS CAN BE RELIABLY MEASURED.

To his credit, Dr. Panzar acknowledges that Proposal One is "easy to understand *and implement*." Panzar at 2 (emphasis added). The Postal Service and Amazon, however, argue that Proposal One should be rejected because inframarginal costs are too difficult to calculate. *See* Postal Service Comments at 16-17; Amazon Comments at 85-88. This effort to use the complexity of the Postal Service's costing procedures as a reason to maintain the status quo fails.

Like many other aspects of postal costing, including the calculation of so-called "volume variable" cost, calculating inframarginal costs involves using some basic modeling assumptions. None of the Postal Service's costing models are perfect, and each relies upon assumptions. As noted above, for example, the Postal Service employs a quadratic polynomial equation in its analysis of city carrier costs to *approximate* the actual underlying cost relationships. As Dr. Neels explains, inframarginal costs can be readily computed using the Postal Service's existing costing model. *See* Neels Reply at 9-16. In fact, the calculation of inframarginal costs is a relatively straightforward mathematical exercise.

Dr. Bradley criticizes Dr. Neels for following the methodology for calculating inframarginal costs used by Charles McBride in his white paper for the Commission. As Dr. Neels shows, however, Dr. Bradley's effort to correct asserted errors in the McBride approach itself has inconsistencies and errors, in addition to steps that appear highly questionable. *See id.* at 17-21. Correcting these errors is straightforward, as Dr. Neels shows in his updated calculations. *See id.* at 21-23.

IV. PROPOSAL ONE'S IMPACT ON RATES AND MARKET CONDITIONS

The Postal Service and other commenters argue that Proposal One should not be adopted because of its potential impact on the prices of competitive and/or market-dominant products. The relevant inquiry, however, is whether the Postal Service's cost attribution practices comply with PAEA, not whether doing so will have an impact that some would prefer to avoid. Moreover, to the extent the Commission considers the impact of Proposal One on rates, the impact will be limited in the short term and, in the long term, will have the salutary effect of ensuring that the Postal Service is properly accounting in its pricing decisions for real costs that exist today and that it must recover to earn a profit. Similarly, to the limited extent the Commission considers prevailing market conditions, those conditions too support adoption of Proposal One.

A. Proposal One Will Increase Transparency and Accountability.

Proposal One does not add new costs to the Postal Service. Instead, it would require the Postal Service to account properly for costs that already exist. If competitive products are not recovering the more expensive variable costs associated with their cost of production, then either market-dominant mailers are being forced to cover them directly or they are being treated as institutional costs for which market-dominant mailers must bear the overwhelming share — or they are not being recovered at all.

Proposal One increases transparency and accountability by bringing these costs to light and ensuring that competitive products pay their fair share of these costs. As the Public Representative observes, "[u]sing both components of variable costs to calculate cost coverages," under Proposal One, "will help improve the [P]ostal [S]ervice's financial viability by more accurately identifying products most in need of cost savings and revenue growth." Public Representative Comments at 31; *see also id*. at 32 ("Measuring cost coverage in this manner signals which products, both market dominant and competitive, are not improving the Postal Service's financial position."); *id.* ("Attributing inframarginal costs to competitive products will reduce the likelihood that market dominant products will subsidize the Postal Service's competitive products.").

In his reply report, Dr. Neels presents an updated table showing the impact of Proposal One on cost coverage figures based on FY2014 data and using the updated inframarginal cost calculations discussed in that report. *See* Neels Reply at 21-24. This table shows that any impact on rates would not nearly be as large as various comments suggest. *See* Amazon Comments at 79 (asserting that Proposal One would "require massive rate increases on a broad range of competitive and market-dominant products"). Adopting Proposal One will not lead to massive rate increases on a broad range of products.[39] It will, however, help ensure that prices have a rational relationship

[39] As pointed out by Valpak, "the Commission's regulatory stance has reduced costs to near irrelevance" for market dominant products. Valpak Comments at 5. To the extent attributable costs are relevant to market dominant products, those costs are but *one factor among the fourteen* to be considered in modifying market dominant rates. *See* 39 U.S.C. § 3622(c)(1)-(14). The Greeting Card Association has explained that, under PAEA, attributable costs bear a "much looser relationship" to market dominant product prices than to competitive product prices. *See* Response of the Greeting Card Association to Petition of United Parcel Service at 2, Dkt. No. RM2016-2 (Oct. 15, 2015). Ultimately, price regulation for market-dominant products is governed by the rate cap, and applications for relief from the cap under exigent circumstances, ensuring that market dominant prices are set in a predictable and reasonable manner. *See* 39 U.S.C. § 3622(d)(1). Moreover, to the extent Proposal One is applied to market-dominant products and some mailers see increased attribution, any increases may be reduced by work-sharing programs.

to costs going forward. As Dr. Panzar recognizes, "[i]gnoring costs does not make them go away." Panzar at 14.

B. The FTC Report and Prevailing Market Conditions Support Proposal One.

While indicating strong support for Proposal One,[40] the Public Representative suggests the Commission may choose to "consider other factors such as the impact of additional attribution on Postal Service revenues, rates, and profits, and the effect on competition in the marketplace for the Postal Service's products and on prices to be paid by the consuming public." *Id.* at 15 In fact, Congress did *not* direct the Commission to consider these other factors in connection with the cost attribution requirement of § 3633(a)(2).

Section 3633(a)(2) imposes a *requirement* that the Postal Service must meet: it directs that the Postal Service *must* demonstrate that each competitive product covers any direct or indirect postal costs with a causal connection to the product. *See NAGCP IV*, 462 U.S. at 830 (holding that where "methods reliably indicate causal connections between classes of mail and postal rates, the Act *requires* that they be employed") (emphasis added).[41] Congress has already determined that any consequences of meeting that requirement are worthwhile.

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[40] *See* Public Representative Comments at 25 ("The Public Representative agrees with UPS that inframarginal costs can be determined, calculated and attributed to products."); *id.* at 53 ("The Public Representative believes that UPS Proposal One's method of measuring inframarginal costs could be accepted as a method of measuring and distributing variable costs as attributable costs.").

[41] As the Public Representative acknowledges, these statements by the Supreme Court indicate that "if the Commission finds cost causation related to competitive products, it must attribute those costs without considering the consequences of that attribution." Public Representative Comments at 15.

In contrast, Congress expressly directed the Commission to consider "the prevailing competitive conditions in the market" in determining the "appropriate share of institutional costs" that are covered by "all competitive products collectively." §§ 3633(a)(3) & (b). Thus, Congress made clear that market conditions be considered *only* with reference to that subsection. *See Nat'l Ass'n of Broadcasters v. F.C.C.*, 569 F.3d 416, 421 (D.C. Cir. 2009) (noting the "general presumption that an omission is intentional where Congress has referred to something in one subsection but not in another").

The Public Representative cites uncodified § 703(d) of the PAEA as the potential basis for the Commission examining "other factors" beyond the analytical principles set forth in § 3633(a)(2). *See* Public Representative Comments at 15-16. Uncodified § 703 required the Federal Trade Commission ("FTC") to report to the Commission on "laws that apply differently" to the Postal Service, as part of the broader goal of putting an end to those laws. Pub. L. 109-435, Title VII, § 703, Dec. 20, 2006, 120 Stat. 3206. The FTC Report had a fairly narrow scope.[42] Nevertheless, to the extent it is considered, the FTC Report fully supports Proposal One.

The FTC Report identified numerous legal advantages enjoyed by the Postal Service and the "implicit subsidies" it receives as a result, including "implicit subsidies that the USPS receives due to . . . its postal and mailbox monopolies [which] mask from consumers the USPS's true costs of providing competitive services." FTC Report at 85. According to the FTC, "the current practice of not requiring the USPS to account for these implicit subsidies is likely leading the USPS to charge artificially low prices for its

[42] *See* Fed. Trade Comm'n, Accounting for Laws That Apply Differently to the United States Postal Service and Its Private Competitors (2007) ("FTC Report").

competitive products." *Id.* Thus, the FTC recommended that the Commission "consider taking action to neutralize the effect of the USPS's implicit subsidies by requiring the USPS to account for them when calculating its costs." *Id.* at 81.

Proposal One neutralizes some of the effects of the implicit subsidies associated with the letter monopoly by requiring the Postal Service to attribute inframarginal costs caused by competitive products. It will also help prevent the Postal Service from masking from the public the true costs of providing competitive services. Thus, it is fully consistent with the FTC Report and Congress' broader concerns.

Moreover, while Congress did not direct the Commission to consider prevailing market conditions in connection with § 3633(a)(2), the available data indicates that the Postal Service's ability to ignore major portions of its variable costs has allowed it to charge artificially low rates for key competitive products and services — including products and services sold in rapidly growing markets, like e-commerce.

For example, as the *Wall Street Journal* and other news outlets have observed, the "Postal Service is aggressively slashing prices to attract big e-commerce companies"[43] and "snap up market share in e-commerce shipping."[44] In September 2014, the Postal Service cut its published prices for certain segments of Priority Mail well below those of its private competitors in the market. *See* United Parcel Service, Inc.'s Response to Chairman's Information Request No. 1 at 9-10, Dkt. No. RM2016-2

[43] Laura Stevens, *U.S. Mail Cuts Prices, Chafing UPS and FedEx*, WALL ST. J. (Sep. 4, 2014), http://www.wsj.com/articles/u-s-mail-cutting-rates-to-win-e-commerce-business-1409850185.

[44] Post & Parcel, *USPS Seeks e-Commerce Market Share with Priority Mail Price Cut* (Jul. 2, 2014), http://postandparcel.info/61751/news/ markets/usps-seeks-e-commerce-market-share-with-priority-mail-price-cut/.

(Dec. 10, 2015) ("UPS Response to CHIR 1"). The products receiving the largest cuts were those increasingly used by e-commerce companies. *Id.*

The Postal Service argues that "[t]hose price decreases were balanced by price increases in other price cells, such that the weighted-average Priority Mail price changed by 0 percent." Postal Service Comments at 36. But this reliance on the weighted-average price obscures how drastic the price cuts were in important commercial rate categories. The Postal Service reduced its rates as much as *58%* for packages shipped to zones 1-5 and weighing between six and twenty pounds. Those, as well as the rate cells weighing between one and five pounds in which the Postal Service maintained substantial price advantages, are the rate cells most popular for the e-commerce market that is a critical growth area for private sector parcel companies.

The Postal Service also points to its January 2016 rate adjustments. But as the Public Representative noted in that docket:

> [T]he most reasonable explanation for why the Postal Service can increase prices by the proposed amounts is that *the current prices are set too low*, despite meeting the applicable regulatory standards. Consequently, the Public Representative questions the accuracy of the accepted costing methodology to set a reasonable price floor. *It seems likely that the accepted methodology does not attribute all appropriate costs to competitive products.*

Public Representative Comments on Postal Service Notice Concerning Changes in Rates of General Applicability for Competitive Products at 5, Dkt. No. CP2016-9 (Nov. 3, 2015) (emphases added). Moreover, the data relied upon by the Postal Service to suggest that these rates increased again focuses on the *overall* Priority Mail category, not key segments most popular among e-commerce mailers. In those key segments, the Postal Service retained its 2014 discounts.[45]

The Postal Service has also leveraged its accounting advantage on last mile deliveries. Under the status quo, parcels ride nearly for free on market-dominant supported mail routes and are required to cover only the *marginal* cost of adding in one additional parcel to an infrastructure largely paid for by other products. Because the Postal Service can charge artificially low prices, major e-commerce retailers *and even major rivals like UPS and FedEx* elect not to deliver shipments on their own because the Postal Service's final mile induction rates cannot be matched for most deliveries. In fact, as Amazon points out in its own comments, the Postal Service's final mile rates are so low that companies are changing their operational processes to shift their last-mile delivery to the Postal Service.[46]

The Postal Service has also increasingly used negotiated service agreements ("NSAs") to exploit its cost attribution advantages. The Public Representative notes that, in seeking approval for these heavily discounted rates, the Postal Service represented that it was not pricing below cost. *See* Public Representative Comments at 45. But the status quo measure of the Postal Service's cost — *marginal cost* — is precisely what gives it the unfair advantage over its rivals.

The Postal Service's ability to set rock bottom prices that would be unsustainable if it were a private sector company is distorting competition today and will increasingly

[45] For instance, for Commercial Base prices, discounts ranging from 7% to 53% below pre-September 2014 rates remain for packages weighing between six and twenty pounds. *See* UPS Response to CHIR 1 at 12. The same is true for Commercial Plus rates, where discounts remain between 9% and 44% for packages weighing between six and twenty pounds. *Id.*

[46] *See* Amazon Comments at 2, 6.

relegate existing private sector companies to more niche roles. It will also discourage market entry by innovative and efficient private sector rivals. The Commission must act now to stop this from happening.[47]

V. <u>3633(A)(1): THE CURRENT "SUBSIDIZATION" TEST SHOULD BE SUPPLEMENTED TO MEET CONGRESS' BROADER GOALS</u>.

Turning to the "subsidization" test of § 3633(a)(1), the fundamental question for the Commission is whether Congress' concern about preventing "the subsidization of competitive products by market-dominant products" is limited solely to the classic cross-subsidization test solely focused on protecting market-dominant consumers.

As Dr. Panzar explains, and as Amazon acknowledges, even if the answer to that question is yes, that test would still require more than is being done today. In addition to the existing "group test," the classic cross-subsidization test would require the Postal Service to test whether *each product* covers its own incremental cost and whether *each combination of two or more products* collectively covers the incremental costs of the combination. *See* Amazon Comments at 82; *see also* Panzar at 2-3 (citing Gerald Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 Am. Econ. Rev. 966 (1975)).

Adding these tests to the existing group test, however, would only be a small step forward. That is because, as UPS's Petition explains, the incremental cost test, by

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[47] As the Postal Service has implemented price cuts since 2014, it has gained Priority Mail market share in four consecutive quarters, enjoying growth at or above 1.0% in the second and third quarter of 2015. *See* UPS Response to CHIR 1 at 13. The Postal Service argues that these market share changes are inaccurate because FedEx uses a different quarterly calendar than do UPS and the Postal Service. *See* Postal Service Comments at 37. This argument is mistaken. UPS matched quarters to synch disparate reporting timeframes, and thereby accounted for seasonal impacts on the data.

design, works backwards from the *end* of the marginal cost curve. It works in this way because the classic cross-subsidization test is meant to address a discrete, and purely hypothetical question: what would happen if all product volume in question disappeared, but nothing else changed? To answer that question, the test *assumes* that the product (or combination or group) being tested comes last on the curve and thus assigns to that product (or combination or group) responsibility for the *least expensive* variable costs on the curve.[48]

The classic cross-subsidization test arose in the context of a regulated monopolist accused of charging unfairly high prices to some or all of its captive consumers. The purpose of the test was to make sure that the various *customers* of the monopolist's products are being treated fairly. The test was never intended to address the different purpose of PAEA — ensuring that a massive, state-owned monopolist with a network that reaches into every corner of the country does not distort competition in markets Congress wants to remain competitive.

As a result, this test, standing alone, does not fully address Congress' concern about preventing "subsidization" of competitive products in the context of PAEA. As noted, Congress enacted § 3633 to ensure that the Postal Service competitive products business would stand on its own financial footing, bear all of the costs of the competitive enterprise, and would not be competing unfairly against private sector parcel companies. These issues too are included within Congress' broad command in §

[48] This ordering assumption is built into the test. Amazon and Dr. Panzar acknowledge that "incremental costs, properly defined, are *not* 'order-neutral.'" Panzar at 19.

3633(a)(1) that the Commission must "prohibit the subsidization of competitive products by market-dominant products."[49]

In its petition, UPS showed how the existing test can be supplemented with an *order-neutral* test that would address Congress' additional concerns. *See* Petition at 23-25. Neither the Postal Service nor Amazon have provided any persuasive reason not to adopt this additional subsidization test.

PROPOSAL TWO

VI. THE CRITICISMS OF PROPOSAL TWO LACK MERIT AND FAIL TO ADDRESS THE CURRENT PROBLEMS WITH COST CLASSIFICATION.

This docket has shown that the Postal Service does not understand the massive amount of costs it classifies as institutional and does not attribute to products. Even as the Postal Service seeks to justify a larger exigent rate increase before the D.C. Circuit on the ground that its "institutional costs are largely either *fixed network costs* that cannot be eliminated merely because mail volume declines, or costs associated with congressional mandates that cannot be cut under existing law,"[50] in this docket the Postal Service has disclaimed knowing which of its costs are "fixed" and acknowledged that its institutional costs include large volumes of variable costs in the form of inframarginal costs.

The Postal Service has had ample opportunity to explain the basis for its decision not to attribute certain cost pools to products because they are supposedly fixed network costs. But the Postal Service has failed to identify any sound basis for these

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[49] *See supra* note 28. Congress purposefully used broad language in § 3633(a)(1). If it had intended for the Commission only to apply the standard cross-subsidization test, it could have said that directly.

[50] Brief of the United States Postal Service at 8, *U.S. Postal Serv. v. Postal Regulatory Comm'n*, No. 15-1297 (D.C. Cir. Jan. 4, 2016).

classifications. It has provided neither a coherent methodology nor an empirical basis for its classifications.

The only person who has offered a solution to this problem is Dr. Neels. In response, the Postal Service, Amazon, and other commentators criticize Dr. Neels' proposed solution for not meeting a standard that is far higher than the standard to which they hold the Postal Service's own cost classification processes.

Under 39 C.F.R. § 3050.11, to approve a change in an analytical principle, the Commission need only "find that the proposed change improves the quality, accuracy, or completeness of the data (or the analysis of data) in the annual periodic reports the Postal Service files with the Commission." Order Approving Analytical Principles Used in Periodic Reporting at 42, RM2015-7 (Oct. 29, 2015) (citing 39 C.F.R. § 3050.11(a)). Proposal Two represents an improvement over the status quo.[51] Accordingly, Dr. Neels' proposed solutions, as discussed below, should be adopted.

A. The Postal Service's Comments Do Not Resolve Concerns About Its Cost Classification Practices.

In Proposal Two, UPS identified 37 components containing costs that the Postal Service treats as fixed but that the data indicates are actually fully or partially variable,

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[51] The Public Representative asserts that "[t]hose who propose changes in analytical methods bear the burden of persuasion," based largely on statements made by the Commission in its FY 2007 Annual Compliance Determination. Public Representative Comments at 19. The Order quoted by the Public Representative applies to "those who would advocate introducing changes in analytical methods *in the Postal Service's first annual compliance report*" and that "*[i]n this docket*, the Commission follows a general policy that only changes that are reasonably balanced updates of input data . . . will be approved." *Id.* at 19 (quoting ACD FY 2007 at 9-10). As the FY 2007 Annual Compliance Determination makes clear, this was because it was a response to "the first ACR filed with this Commission and represent[ed] a period of transition," and was thus undertaken with certain "unique and non-recurring factors in mind." ACD FY 2007 at 6, 8. Those factors are not present here.

as demonstrated by robust and statistically significant econometric tests. These are costs that the Postal Service does not attribute to products, based on its assumption that they do not vary with changes in volume. Importantly, Dr. Neels presented "evidence of a systematic bias in Postal Costing to overstate fixed costs." Neels Report at 1.

In Chairman's Information Request No. 2, the Commission asked the Postal Service to explain "the methodology the Postal Service uses to determine whether costs are fixed." Chairman's Information Request No. 2 at 2, Dkt. No. RM2016-2 (Nov. 20, 2015). In response, the Postal Service did not describe any methodology or any empirical basis for its cost classifications. Instead, the Postal Service claimed it has "no need … to determine which of its costs are fixed, *and it does not do so*." USPS Response to CHIR 2 at 12. The Postal Service then vaguely referred to unspecified "operational and engineering analyses" it uses "to identify cost pools that have a zero volume variability, meaning the costs do not change with variations in the amount of volume handled." *Id.* at 11.

But the Postal Service did not identify any empirical analyses or methodology for determining whether a component has "zero volume variability" either.[52] The conclusion to be drawn from all of this is clear: the Postal Service utilizes an *ad hoc* cost classification approach based on its own subjective judgments. Often, these judgments

[52] In response to the Postal Service's statements, UPS identified 41 cost pools by name that the Postal Service treats as fixed and requested the Commission to ask the Postal Service, again, to identify any methodology used that led to that classification. The Postal Service chose to oppose the request. It then ignored this question in its initial comments, and to this day it has not identified any methodology or empirical basis for its classification of *any* of these cost pools as either "fixed" or as having "zero volume variability."

were made long ago and under different circumstances. As Charles McBride observed, they were apparently often made "based on the favorable postal economic environment of the time," and more recent experience "has shown that many of these assumptions were overly optimistic." McBride at 10. Dr. Neels' work confirms these suspicions.

Nevertheless, the Postal Service has made no effort to introduce more rigorous practices to the classification of these cost pools. Even in the City Carrier Street Time docket, for example, it clung to old classifications of Network Travel Time as fixed without testing that assumption with the actual data. Instead, the Postal Service has focused its energy on attacking Dr. Neels' work, claiming it does not meet a high bar of econometric rigor to which it refuses to hold up its own cost classification practices. It is joined in that endeavor by Amazon, who had multiple economists put Dr. Neels' work under the microscope in a way Amazon shows no inclination to do for the Postal Service's own ad hoc assumptions. Leaving in place a flawed status quo that is failing to attribute to competitive products costs that can and should be attributed is, however, intolerable under PAEA. Moreover, these various criticisms cannot withstand scrutiny. Often, the various attacks on Dr. Neels' regressions are generalized and nonspecific. Where they are specific, they do not pass muster. In his reply report, Dr. Neels shows that these criticisms lack merit and do not undermine his results. *See* Neels Reply at 17-23.

The Commission must not allow the sheer number of criticisms of Dr. Neels' work made by Postal Service and Amazon experts to create the false impression that the criticisms are *valid*. They are not. No criticism diminishes the fact that Dr. Neels has demonstrated a widespread, systematic, and quantitatively and statistically significant tendency for the Postal Service costing procedures to understate its variable costs.

B. Dr. Neels' Recommendations Should be Adopted.

Dr. Neels acknowledged that a complete solution to the problem of how to reclassify the costs pools that have been misclassified as fixed may not be feasible in the short term, particularly for those pools where the incumbent costing model is incorrect. But there are a number of cost components where immediate changes are warranted.

As discussed in his reply report, Dr. Neels has narrowed his recommendations to those 27 components in which he found statistically significant evidence that variable costs have been understated, that contain no inframarginal costs, and that are currently regarded either as entirely fixed, or are assumed to have a split between institutional and attributable costs that mirrors that calculated in some other component. *See* Neels Reply 41-44. In these components specifically, there is no legacy model whatsoever and their classification as institutional is driven wholly by assumptions rather than data. Consequently, Dr. Neels' findings are undoubtedly an improvement over the status quo treatment, and they should be adopted.

In other circumstances, the Commission has accepted proposals that are a step forward, even while recognizing they are not perfect and setting the stage for further proceedings. The Commission did this, for example, in the City Carrier Street Time docket, where it accepted Proposal Thirteen because it was an improvement over the existing model, even while recognizing that there may be other superior approaches to Proposal Thirteen itself. *See generally* Order Approving Analytical Principles Used in

Periodic Reporting, RM2015-7 (Oct. 29, 2015). The Commission should follow the same course here with regard to these specific components.

VII. CONCLUSION

For the foregoing reasons, the Commission should adopt Proposals One and Two.

Respectfully submitted,

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